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David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC SUBMISSION

Re: **Notice of Proposed Rulemaking on Protection of Collateral of Counterparties to Uncleared Swaps, RIN 3038-AD28**

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the “Working Group”), Hunton & Williams LLP submits the following comments in response to the request for public comment set forth in the Notice of Proposed Rulemaking, *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy* (the “Proposed Rule”), issued by the Commodity Futures Trading Commission (“CFTC” or “Commission”) and published in the *Federal Register* on December 3, 2010,¹ proposing to increase protections for customer assets posted as collateral for uncleared swaps.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to customers, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

¹ *Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy*, Notice of Proposed Rulemaking, 75 Fed. Reg. 75,432 (Dec. 3, 2010).

II. EXECUTIVE SUMMARY.

The Working Group supports the Proposed Rule because it empowers end users to effect the segregation of their initial margin. It applauds the ability of counterparties to enter into tri-party agreements with Swap Dealers or Major Swap Participants and custodians for the protection of their collateral. This will not only allow them to ensure the safety of their assets in times of economic uncertainty, but also will help financial markets remain liquid in the event of a Swap Dealer or Major Swap Participant default. At the same time, the Working Group recommends that the provisions of the Proposed Rule imposed on custodial relationships not be mandatory, *i.e.*, that parties should remain free to negotiate all the respective terms of their transactions. In this way, the Commission will avoid imposing unwanted additional costs on parties that do not want to bear them.

In addition, the Commission should clarify certain provisions of the Proposed Rule to allow market participants to better understand its potential application and impact. The Proposed Rule should also be amended to allow Swap Dealers and Major Swap Participants to make required notifications in master agreements and not on a transaction-by-transaction basis, and the notifications should be made to the appropriate person as determined by the counterparty. Finally, the perjury standard with regards to the withdrawal of collateral should be removed from the Proposed Rule as it unnecessarily exposes individuals to criminal liability. The Commission's civil penalty authority is adequate to deter conduct by individuals involving the intentional misrepresentation of their right to remove collateral.

III. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. THE TERMS OF SEGREGATION SERVICES SHOULD BE LEFT TO NEGOTIATION BETWEEN COUNTERPARTIES.

Among other questions, the Commission asks which party to an uncleared swap should be permitted to select a custodian.² The Working Group respectfully suggests that outside the election to segregate collateral, which is the right of a Swap Dealer or Major Swap Participant's counterparty, all other terms and parameters of a custodial relationship should be left to negotiation between counterparties, and where appropriate counterparties and the custodian. The terms subject to such negotiation should include, but should not be limited to, the identity of the custodian, the cost of the custodial arrangement, and the terms of the custodial arrangement. Uncleared bilateral swaps are generally customized agreements with a number of bespoke terms. The terms of any custody agreement for such swaps will likely be dependent, at least partially, on those bespoke terms. Accordingly, the terms of a custody agreement entered into under the Proposed Rule should be left to the counterparties and the custodian to negotiate based on their unique circumstances.

² *Proposed Rule* at 75,434.

B. ABILITY TO NEGOTIATE OTHER COLLATERAL PROTECTION AGREEMENTS SHOULD BE PRESERVED.

Although the Working Group supports the option of counterparties to require segregation for initial margin posted on uncleared swaps, this option should not be implemented in a way that limits the ability of parties to negotiate alternative or additional collateral protections and other commercial arrangements. For example, if a customer desires to segregate collateral posted for other non-swap transactions with a Swap Dealer or Major Swap Participant in the same account as collateral posted on an uncleared swap, then it should be permitted to do so. Alternatively, if a customer chooses to segregate its collateral in a Swap Dealer's omnibus customer account with a custodian, as such option is likely to be lower cost than the individual account option available under the Proposed Rule, then it should be permitted to do so. In sum, customers should have the freedom to use any form of collateral protection arrangement, not just those arrangements contemplated by the Proposed Rule.

In addition, the Working Group respectfully requests that the Commission clarify that the requirements imposed by the Proposed Rule do not apply to uncleared swaps entered into prior to the effective date of the Proposed Rule. Such swaps were fully negotiated based on the options then available to the counterparties. Allowing a Swap Dealer or Major Swap Participant's counterparties to now have an express option to segregate collateral would nullify carefully negotiated agreements.

C. CLARIFICATION OF CERTAIN TERMS.

Before market participants are fully able to offer substantive and detailed comments on the Proposed Rule, the Commission must provide clarification as to what certain terms used in the Proposed Rule mean in practice. First, the Commission should provide clarification on the definition of "segregate" as defined in proposed CFTC Rule 23.600. The Working Group interprets the definition as providing for segregation in individual customer accounts. Some market participants, however, may view this definition as ambiguous as to the form or forms of account segregation that would satisfy the definition. Thus, as a threshold matter, the Commission should address whether this definition contemplates a situation in which (i) there is an individual account for each legal entity trading with a Swap Dealer or Major Swap Participant, or (ii) a Swap Dealer or Major Swap Participant may hold all customer collateral in an omnibus customer account with a custodian?

Second, the Working Group respectfully requests that, in the event that the Commission does not allow Swap Dealers, Major Swap Participants and their counterparties to determine which entities qualify as a custodian, the Commission should provide guidance as to what qualifications are necessary for an entity to serve as a custodian under the Proposed Rule. Without knowing what entities are permitted to serve as custodians, potential counterparties cannot provide completely informed comments as to the Proposed Rule's efficacy and impact.

Third, the Proposed Rule does not indicate when a Swap Dealer or Major Swap Participant, as the secured party, or their counterparty, as the collateral provider, may withdraw collateral from a segregated account established under the Proposed Rule. To allow market participants to fully understand the implications of the Proposed Rule, the Commission should either offer additional guidance that provides the necessary clarity, or should affirmatively state that these issues are to be resolved through bilateral negotiation between counterparties.

D. PERJURY STANDARD SHOULD BE AMENDED.

The Working Group respectfully requests that the Commission amend proposed CFTC Rule 23.602(b)(1) to require a party, when making a request for a custodian to turn over collateral, to attest that to the best of their knowledge they are entitled to control of the assets. The imposition of a potential criminal penalty by using a perjury standard is unnecessary. It unnecessarily exposes individuals who make good faith determinations, later disputed, to potential criminal liability. The potential for civil liability for making false statements should be sufficient to (i) allow the Commission and counterparties to seek penalties or recover damages in appropriate circumstances, and (ii) deter fraudulent conduct by counterparties improperly seeking control of segregated assets.

E. NOTIFICATION REQUIREMENTS SHOULD BE AMENDED.

CFTC Proposed Rule 23.601(a) requires a Swap Dealer or Major Swap Participant to notify a counterparty of their right to require segregation at the beginning of each swap transaction. However, CFTC Proposed Rule 23.601(e) states that “notification...to a particular counterparty by a particular Swap Dealer or Major Swap Participant need only be made once in a calendar year.” The Working Group requests clarification as to whether the Proposed Rule requires a once-a-year notification on each transaction or a once-a-year notification to each counterparty. A requirement for transaction-by-transaction notification could impose an unnecessary administrative burden on Swap Dealers and Major Swap Participants. The Working Group respectfully requests that the Commission allow counterparties to make the required notification in a master agreement that sets forth the parameters of the trading relationship between two counterparties.

The Proposed Rule requires that the notification of the right to segregation be made to the “highest-level decision maker for the counterparty.”³ The Commission states that the Proposed Rule is intended to ensure that the decision of whether to elect segregation is “taken at an appropriate level of the counterparty organization.”⁴

³ Proposed CFTC Rule 23.601(c).

⁴ *Proposed Rule* at 75,433.

It is the Working Group's position that there are many factors that go into the determination of whether a counterparty would like to segregate collateral posted on an uncleared swap. The highest-level decision maker might not be the appropriate person to make the segregation decision. For example, in a large trading firm the appropriate person might be a desk head, while in a small boutique investment firm the appropriate person might be the chief investment officer. Accordingly, a counterparty should be free to designate the appropriate person to receive the notification of its right to segregation provided that person is empowered to make sure that the notification is received by the decision maker designated by the counterparty to make the segregation decision.

F. TIMING OF ELECTION TO CHANGE SEGREGATION DECISION.

Under the Proposed Rule, a Swap Dealer or Major Swap Participant's counterparty is free to change its segregation election with respect to all uncleared swaps between the counterparty and a Swap Dealer or Major Swap Participant at any time upon the delivery of written notice.⁵ The Working Group respectfully requests that the Commission expressly state that if a party makes an election under the Proposed Rule and does not expressly reserve the right to change that election in the relevant swap trading relationship documentation, then they cannot do so. The Working Group is worried that a counterparty might choose to negotiate a segregation agreement independent of the Proposed Rule and then, if the terms turn out to be unsatisfactory in the future, unilaterally terminate that segregation agreement and elect segregation under the Proposed Rule. Allowing counterparties to choose segregation under the Proposed Rule when they are already a party to a binding segregation agreement could have a detrimental impact on over-the-counter swap markets.

In addition, the Working Group respectfully requests, that in the event a counterparty has expressly reserved the right to change the segregation treatment of its collateral under the Proposed Rule, the Commission require a counterparty's election to change its segregation decisions be implemented as soon as practicable. As the negotiation of custodial agreements and, to a lesser extent, the unwinding of custodial agreements, can be a time consuming process, a more immediate timing requirement would be impractical.

Finally, as proposed CFTC Rule 23.601(f) can be read to imply otherwise, the Working Group requests that a counterparty be permitted to elect different segregation treatment for individual uncleared swaps with a Swap Dealer or Major Swap Participant. The ability to elect different segregation treatment for different swaps is essential for sound risk management practices.

G. REQUIRED QUARTERLY REPORT.

As required under Section 724 of the Act, the Proposed Rule mandates that a Swap Dealer or Major Swap Participant's chief compliance officer report "to each counterparty that

⁵ Proposed CFTC Rule 23.601(f).

does not choose to require segregation of Initial Margin pursuant to § 23.601(a)...on whether or not the back office procedures of the swap dealer or major swap participant relating to margin and collateral requirements were, at any point during the previous calendar quarter, not in compliance with the agreement of the counterparties.”⁶ Making such a report on a quarterly basis would place an unnecessary burden on Swap Dealers and Major Swap Participants. The Working Group respectfully requests that Swap Dealers and Major Swap Participants be permitted to make a representation in a master agreement that during the previous quarter the initial margin protection procedures agreed upon between the counterparties were followed and not violated. That representation should be treated as renewed quarterly.

By requiring a Swap Dealer or Major Swap Participant’s chief compliance officer to report to “each counterparty that does not choose to require segregation of Initial Margin pursuant to § 23.601(a)...on whether or not the back office procedures of the swap dealer or major swap participant were...not in compliance with the agreement of the counterparties,” proposed CFTC Rule 23.604(a) seems to implicitly state that there are only two options for segregation of initial margin to an uncleared swap (i) segregation under the Proposed Rule, and (ii) possession by a Swap Dealer or Major Swap Participant. Proposed CFTC Rule 23.604(a) does not account for a segregation agreement with an independent custodian outside of the Proposed Rule. As discussed above in Section III.B., the Proposed Rule should not prevent market participants from choosing segregation options outside of those offered under the Proposed Rule. Accordingly, the Working Group requests that proposed CFTC Rule 23.604(a) be clarified to require a Swap Dealer or Major Swap Participant to make quarterly representations as to procedures in place for the protection of collateral only if they are in fact in possession of such collateral.

H. EFFECTIVE DATE.

The Commission, in the release to the Proposed Rule, suggests an effective date of six months after the promulgation of a final rule. In comments filed with the Commission on January 24, 2011, in response to the Proposed Rule on Registration Requirements for Swap Dealers and Major Swap Participants,⁷ the Working Group recommended that the Commission adopt a 12 month period prior to registration during which commercial entities would be permitted to determine whether they were a Swap Dealer or Major Swap Participant and to restructure their businesses to comply with the requirements imposed on such classes of entities. The Working Group also recommended that the Commission then phase in the compliance requirements for Swap Dealers and Major Swap Participants in a rational manner over an appropriate period of time.⁸ The Working Group requests that the Commission implement the requirements imposed by the Proposed Rule during the proposed phase-in period.

⁶ Proposed CFTC Rule 23.604(a).

⁷ See the Working Group’s comments filed with the Commission on January 24, 2011, in response to the Commission’s Proposed Rulemaking on *Registration Requirements for Swap Dealers and Major Swap Participants*, 75 Fed. Reg. 71,379 (Nov. 23, 2010).

⁸ *Id.*

The negotiation of custody agreements can be a complex and time consuming process. Given the uncertainty regarding basic requirements of the Proposed Rule, such as the lack of clarity regarding what qualifications are necessary for an entity to serve as a custodian, it is difficult to provide an accurate assessment of the time necessary to come into compliance with the Proposed Rule. If, for example, permissible custodians were restricted to the limited group of financial entities with AAA credit ratings, then negotiations to establish custodian accounts could take a substantial period of time given the limited options. In light of the above, the Working Group respectfully suggests that a proper effective date would be at least 12 months after the issuance of a final rule.

I. OPEN COMMENT PERIOD.

Given the interconnectedness of all of the rulemakings under Title VII of the Act, and given that the Act and the rules promulgated thereunder entirely restructure over-the-counter derivatives markets, the Working Group respectfully requests that the Commission hold open the comment period on all rules promulgated under Title VII of the Act until such time as each and every rule required to be promulgated has been proposed. Market participants will be able to consider the entire new market structure and the interconnection between all proposed rules when drafting comments on proposed rules. The resulting comprehensive comments will allow the Commission to better understand how their proposed rules will impact Swap markets.

IV. CONCLUSION.

The Working Group supports tailored regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding. If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ R. Michael Sweeney

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